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Privitizing Social Security: Administration and Implementation

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Privatizing Social Security: Administration and Implementation

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I. Introduction

The existing social security program provides retirement income security for the vast majority of American workers and their families. Social Security functions as a large-scale defined benefit system that is administered by the federal government and financed on a pay-as-you-go basis. The government collects contributions in the form of a flat-rate payroll tax on the wages of current workers and pays benefits to retired or disabled workers and eligible family members based on a statutory formula reflecting each worker's lifetime earnings history.¹ Although the system currently generates a modest annual

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1. In general, "Social Security" refers to the Federal Old-Age, Survivors, Disability, and Hospital Insurance Program. For an overview of the program, see generally STAFF OF HOUSE COMM. ON WAYS AND MEANS, 106TH CONG., BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1-96 (Comm. Print 2000).

surplus, the long-term outlook is less encouraging. Official projections indicate that around 2037, while baby boomers are still drawing retirement benefits, the system will no longer be able to pay promised benefits in full.² Restoring fiscal balance to the Social Security system clearly will require reform of some sort, but both the direction and the scope of reform are highly controversial.

Proposals for privatizing at least part of the Social Security system play an increasingly prominent role in the debate over reform.³ Broadly speaking, privatization refers to a shift toward a defined contribution system in which each worker sets aside funds in a personal retirement account over the course of his or her working life and controls the investment of funds in the account.⁴ Thus, in a privatized system, the level of retirement benefits for each participant depends on the accumulated balance in his or her account at the time of retirement. Proponents point out that privatization would give individual participants an enhanced sense of ownership and control over their retirement savings, as well as opportunities to achieve higher investment returns from access to private capital markets.⁵ Furthermore, proponents contend that

2. See BD. OF TRUSTEES, FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, 2000 ANNUAL REPORT 3 (2000). See generally Michael J. Boskin, *A Framework for Considering Social Security Reform*, in FRAMING THE SOCIAL SECURITY DEBATE: VALUES, POLITICS, AND ECONOMICS 29, 37 (R. Douglas Arnold et al. eds., 1998) [hereinafter FRAMING THE SOCIAL SECURITY DEBATE] (noting that, even in absence of long-run actuarial problems, it might be useful to consider "nontrivial changes" in current tax and benefit structure).

3. See generally GEN. ACCOUNTING OFFICE, SOCIAL SECURITY: EVALUATING REFORM PROPOSALS (GAO/AIMD/HEHS-00-29), REPORT TO CONG. REQUESTERS (1999) (providing overview of current reform proposals). A majority of the members of the 1994-1996 Advisory Council on Social Security supported some form of personal accounts but offered divergent proposals for the structure and implementation of such accounts. See I REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY 28 (1997) [hereinafter ADVISORY COUNCIL REPORT] (proposing "individual account" (IA) plan for government-administered accounts with constrained investment options); *id.* at 30 (proposing "personal security account" (PSA) plan for decentralized accounts with broad investment options).

4. See Martin Feldstein, *Introduction*, in PRIVATIZING SOCIAL SECURITY 1, 2 (Martin Feldstein ed., 1998) (defining "essence" of privatization as giving individuals "control over their own investments"). The shift from a defined benefit to a defined contribution system also has far-reaching implications for the overall allocation of risk both within and across generations. See Peter A. Diamond, *The Economics of Social Security Reform*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 38, 44 (noting that "[w]ith a defined-benefit system, the risks can be spread more widely, with the economic advantages that come from wider pooling of risks").

5. See ADVISORY COUNCIL REPORT, *supra* note 3, at 104-05 (noting that PSA plan would "give workers real ownership claims over the contributions" and criticizing existing Social Security system as providing "a rate of return . . . much lower than the real return to private capital").

higher investment returns could ease the transition from the existing pay-as-you-go system to an advance-funded system of personal accounts and could eventually produce long-term economic gains.⁶

While most privatization proposals link personal accounts with advance funding and investment diversification, these features are analytically distinct.⁷ It is possible, at least in theory, to achieve higher investment returns through advance funding and diversified investment in a centralized, government-administered system without introducing personal accounts.⁸ Once projected investment returns are adjusted for market risk and the transition costs of advance funding are taken into account,⁹ however, projected increases in the aggregate rate of return may turn out to be much less dramatic than they initially appear.¹⁰ Moreover, privatization proposals involve serious tradeoffs and conflicts both within and across generations of workers, which ultimately must be resolved through the political process.¹¹

6. See Feldstein, *supra* note 4, at 16-17 (noting potential gains from privatization); Martin Feldstein & Andrew Samwick, *The Transition Path in Privatizing Social Security*, in *PRIVATIZING SOCIAL SECURITY* 215, 218-21 (Martin Feldstein ed., 1998) (arguing that fully privatized system with personal accounts could be funded by payroll tax of around two percent, based on assumption that accounts would receive estimated nine percent pretax rate of return after rebate of corporate tax); cf. Randall P. Mariger, *Social Security Privatization: What Are the Issues?*, 52 NAT'L TAX J. 783, 783 (1999) (arguing that "free lunch arguments for privatization are false").

7. See John Geanakoplos et al., *Would a Privatized Social Security System Really Pay a Higher Rate of Return?*, in *FRAMING THE SOCIAL SECURITY DEBATE*, *supra* note 2, at 1338-41.

8. In theory, higher returns also could be achieved through partial advance funding of the existing defined benefit system, coupled with centralized investment of a portion of social security trust funds in private capital markets. See ADVISORY COUNCIL REPORT, *supra* note 3, at 25-27 (proposing incremental changes in existing system, including investment of trust funds in stock market, under "maintain benefits" (MB) plan); *infra* notes 94 & 100-02 and accompanying text (discussing centralized, government-administered trust fund). The economic benefit of such a stock-for-debt swap would be most significant for constrained individuals who currently do not participate in diversified capital markets. See Geanakoplos et al., *supra* note 7, at 138, 152-54; cf. Feldstein & Samwick, *supra* note 6, at 217 (noting that "while the funds could in principle be collected and invested by the government, we believe that there are many reasons for preferring a decentralized system"). See generally Pierre Pestieau & Uri M. Possen, *Investing Social Security in the Equity Market: Does it Make a Difference?*, 53 NAT'L TAX J. 41 (2000).

9. In effect, implementing advance funding would require that current workers pay twice – once to pay benefits already promised to current retirees under the existing system and once to finance their own personal accounts. By one recent estimate, the transition cost amounts to an unfunded liability of around \$9 trillion, representing the difference between benefits already paid out or promised under the existing system and contributions paid into the system to date. See Stephen C. Goss, *Measuring Solvency in the Social Security System*, in *PROSPECTS FOR SOCIAL SECURITY REFORM* 16, 34 (Olivia S. Mitchell et al. eds., 1999).

10. See Geanakoplos et al., *supra* note 7, at 148-57.

11. See generally BARRY BOSWORTH & GARY BURTLESS, *THE EFFECTS OF SOCIAL SECURITY REFORM ON SAVING, INVESTMENT, AND THE LEVEL AND DISTRIBUTION OF WORKER WELL-BEING* (Ctr. for Ret. Research at Boston Coll., Working Paper, 2000) (arguing that

The purpose of this Article is not to argue the case for or against privatization or to evaluate the merits of specific reform proposals.¹² Instead, we consider administrative issues that bear on the structure and implementation of any universal, mandatory system of personal accounts. In general, the central issues in designing personal accounts involve tradeoffs between relatively standardized, low-cost options with constrained individual choice and limited risk on the one hand and more flexible, higher-cost options with enhanced opportunities for individual control and greater risk on the other hand.¹³ Moreover, the range of available investment and payout options may have a direct impact on the nature and degree of government involvement. To a large extent, the structure of a system of personal accounts depends on decisions concerning acceptable levels of cost, risk, and control for individual participants.¹⁴ Although administrative issues only recently have begun to attract widespread attention, they are crucial in evaluating the practical feasibility of a system of personal accounts.

II. Administrative Issues

Establishing and administering personal accounts for all workers covered by Social Security presents formidable challenges that no existing system is fully equipped to meet.¹⁵ Any system of personal accounts must perform the following three basic functions: collecting contributions and maintaining

replacing all or part of existing defined benefit system with defined contribution system may increase national savings, capital stock, and wages over lengthy time horizon, while reducing workers' or retirees' consumption in short run); Karen C. Burke & Grayson M.P. McCouch, *Perspectives on Social Security Reform*, 4 FLA. TAX REV. 417 (1999) (discussing proposals for Social Security reform).

12. Accordingly, we do not discuss the role of a privatized component as a "carve-out" from or an "add-on" to the existing social security system, nor do we discuss alternative sources of financing for a system of personal accounts (i.e., from increased taxes, additional government debt, or revenue diverted from other uses). See GEN. ACCOUNTING OFFICE, SOCIAL SECURITY: CAPITAL MARKETS AND EDUCATIONAL ISSUES ASSOCIATED WITH INDIVIDUAL ACCOUNTS (GAO/IGD-99-115), REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS 5-6 (1999) [hereinafter GAO, CAPITAL MARKETS].

13. See GEN. ACCOUNTING OFFICE, SOCIAL SECURITY REFORM: IMPLEMENTATION ISSUES FOR INDIVIDUAL ACCOUNTS (GAO/HEHS-99-122), REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS 4 (1999) [hereinafter GAO, IMPLEMENTATION ISSUES].

14. See LAWRENCE H. THOMPSON, ADMINISTERING INDIVIDUAL ACCOUNTS IN SOCIAL SECURITY: THE ROLE OF VALUES AND OBJECTIVES IN SHAPING OPTIONS 18 (Urban Inst., Retirement Project Occasional Paper No. 1, 1999) (noting that "variation among the [personal account] plans can be traced to differences of opinion about the relative importance" of different goals).

15. See NAT'L ACAD. OF SOC. INS., REPORT OF THE PANEL ON PRIVATIZATION OF SOCIAL SECURITY: EVALUATING ISSUES IN PRIVATIZING SOCIAL SECURITY 29 (1998) [hereinafter PANEL ON PRIVATIZATION] (noting that privatized system would require establishment of more than 140 million personal accounts; by comparison, no existing private firm administers more than six million accounts).

records, investing accumulated funds, and determining and paying benefits. In the existing social security system, all of these functions are centralized in the hands of the federal government. In a system with personal accounts, by contrast, it would be possible to shift some of these functions from the government to individual participants or to financial intermediaries. Choices among different methods of implementing personal accounts may have far-reaching consequences for the long-term financial and political viability of a privatized system.

A. Collection and Recordkeeping

The existing social security system provides a useful starting point for a centralized, government-administered system of collecting contributions and crediting them to personal accounts for individual participants. Under existing law, an employer withholds payroll taxes from each employee's wages and deposits those taxes (together with the employer's share) with the Internal Revenue Service.¹⁶ The Internal Revenue Service monitors the total amount of payroll taxes collected but does not earmark amounts for individual employees.¹⁷ Similarly, although the Social Security Administration maintains records of each individual employee's reported earnings, it does not match those earnings with payroll taxes actually collected from the employer.¹⁸ Thus, the government cannot identify payroll tax receipts attributable to a particular employee until the employer submits its annual W-2 wage statements for each employee.¹⁹

Riding piggyback on the payroll and income tax system would avoid wasteful duplication of existing collection and recordkeeping mechanisms. Nevertheless, some modifications would be necessary to ensure timely crediting of contributions to personal accounts.²⁰ To mitigate the impact of the time lag between collection and posting to personal accounts, payroll taxes received from employers could temporarily be pooled in a relatively safe investment vehicle, such as a money market fund.²¹ Upon identifying the amount of payroll tax collections attributable to each individual employee, the govern-

16. See *id.* at 30 (noting that 6.5 million employers report to Social Security Administration annually).

17. See Janice M. Gregory, *Possible Employer Responses to Social Security Reform*, in PROSPECTS FOR SOCIAL SECURITY REFORM 313, 323 (Olivia S. Mitchell et al. eds., 1999).

18. See *id.*

19. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 15.

20. Olivia S. Mitchell, *Administrative Costs in Public and Private Retirement Systems*, in PRIVATIZING SOCIAL SECURITY 403, 417 (Martin Feldstein ed., 1998) (noting that existing system "seems to be slow in tracking earnings and contributions"); see GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 17 (noting delay of seven to twenty-two months in posting earnings to Social Security records).

21. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 17 (discussing alternative methods).

ment could credit the appropriate amount, together with a ratable share of investment earnings, by electronic transfer to the personal account designated on the employee's income tax return.²²

Of course, the function of collecting contributions and crediting them to personal accounts need not be centralized in the hands of the federal government. In theory, employers could perform this function in much the same way as under an existing 401(k) plan.²³ An employer-based approach, however, would represent a substantial new administrative burden, especially for small- and medium-size employers who presently do not offer 401(k) plans.²⁴ There is no reason to assume that employers would operate more reliably or efficiently than the government in crediting contributions to personal accounts, nor is it clear that they would be able or willing to assume this responsibility.²⁵

An even more decentralized approach, modeled on existing individual retirement accounts (IRAs), would rely on individual employees to deposit funds directly into their personal accounts and to report contributions annually on their federal income tax returns.²⁶ An employee-based approach, however, would involve high administrative costs and would raise potentially serious compliance problems.²⁷ Accordingly, there appears to be an emerging consen-

22. See *id.*; Fred T. Goldberg, Jr. & Michael J. Graetz, *Reforming Social Security: A Practical and Workable System of Personal Retirement Accounts*, in ADMINISTRATIVE ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 9, 16-17 (John B. Shoven ed., 2000) [hereinafter ADMINISTRATIVE ASPECTS].

23. Under a 401(k) plan or "cash or deferred arrangement" (CODA), employees may elect to contribute a portion of their salary on a pre-tax basis to fund retirement savings. See I.R.C. § 401(k) (1994).

24. See PANEL ON PRIVATIZATION, *supra* note 15, at 63 (noting that direct deposits by employers would be burdensome for small firms). Although almost all workers are now covered by social security, only around fifty percent of full-time workers in the private sector are covered by any type of employer-provided retirement plan, and around twenty-five million individuals participate in 401(k) plans. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 18. Furthermore, 401(k) plans are disproportionately concentrated among large employers and are "almost nonexistent at small firms." Robert C. Pozen & John M. Kimpel, *Investment and Administrative Constraints on Individual Social Security Accounts*, in PROSPECTS FOR SOCIAL SECURITY REFORM, *supra* note 17, at 377.

25. See ERISA INDUS. COMM., THE VITAL CONNECTION: AN ANALYSIS OF THE IMPACT OF SOCIAL SECURITY REFORM ON EMPLOYER-SPONSORED RETIREMENT PLANS 58 (1998) (describing 401(k) approach as potentially "costly, cumbersome, and counterproductive"); GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 18 (noting that "most employers oppose any additional paperwork burden or costs").

26. Cf. I.R.C. § 408 (1994) (authorizing IRAs). In 1992, around 9.6 million individuals made IRA contributions. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 20.

27. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 20 (noting that "[o]verseeing the large number of accounts, ensuring compliance, and preventing fraud would be significant issues to consider under [an employee-based] model"); Pozen & Kimpel, *supra* note 24, at 377.

sus that "it would be administratively simpler and less costly for the government to send funds directly to fund managers to credit to individual accounts."²⁸

B. Investment Options: Risks, Returns, and Regulation

A system of personal accounts would channel an unprecedented surge of funds into capital markets, and the responsibility for managing these funds would almost certainly fall into the hands of brokers or other financial intermediaries. While the aggregate volume of funds and the number of personal accounts would be very large,²⁹ most accounts would be relatively small. In 1997, around two-thirds of all workers earned less than \$30,000.³⁰ Assuming annual contributions equal two percent of earnings, the amount credited to these workers' personal accounts for 1997 would have been \$600 or less. In defining the range of investment options available to individual participants, it is important to keep in mind the goal of providing retirement security for all participants.

1. Investment Options

A fundamental issue is how much choice participants should have in directing the investment of funds in their personal accounts. A system of personal accounts could offer participants virtually unlimited freedom to choose investment strategies ranging from relatively safe, low-risk portfolios (e.g., money market funds) to those that are high-risk and aggressive (e.g., venture capital or global equity funds). Participants would be able to tailor investment strategies to suit their own preferences for risk and return and might also enjoy an enhanced sense of autonomy and control in planning for retirement. At the same time, a system with a broad range of investment options would be relatively costly to administer and might leave many participants with

28. MARTIN FELDSTEIN & ANDREW SAMWICK, MAINTAINING SOCIAL SECURITY BENEFITS AND TAX RATES THROUGH PERSONAL RETIREMENT ACCOUNTS: AN UPDATE BASED ON THE 1998 SOCIAL SECURITY TRUSTEES REPORT 2 (Nat'l Bureau of Econ. Research, Working Paper No. 6540, 1999); see also Mitchell, *supra* note 20, at 421 (noting that system is likely to be more efficient if "revenue collection and record-keeping functions are handled by a single agency").

29. See GAO, CAPITAL MARKETS, *supra* note 12, at 22 (noting that two percent of payroll was around \$70 billion in 1998 and could rise to around \$220 billion by 2020).

30. See GEN. ACCOUNTING OFFICE, SOCIAL SECURITY REFORM: ADMINISTRATIVE COSTS FOR INDIVIDUAL ACCOUNTS DEPEND ON SYSTEM DESIGN (GAO/HEHS-99-131), REPORT TO THE RANKING MINORITY MEMBER, HOUSE COMM. ON WAYS AND MEANS 25 (1999) [hereinafter GAO, ADMINISTRATIVE COSTS]; see also GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 35 (noting that in 1997, average taxable earnings were \$22,383, and at two percent rate, average contribution would have been around \$448).

inadequate sources of retirement income. Accordingly, some constraints on individual choice may be desirable in order to control administrative costs and to promote retirement policy goals.

Administrative costs can significantly erode the value of an account over time. For example, an annual fee equal to one percent of asset value could reduce the accumulated balance in an account by over twenty percent over the course of a forty-year career.³¹ The level of administrative costs varies with the range of investment options and the level of services provided.³² An actively managed portfolio with full services of the sort offered by many mutual funds might well incur annual administrative costs of over one percent of asset value, while comparable costs for a passively managed index fund with fewer services might be less than one-third of one percent.³³ Thus, one way to control administrative costs would be to offer a narrow choice of investment vehicles with limited services, though such an approach might fail to satisfy participants familiar with high-end products and services available on the open market.³⁴ Furthermore, it is not clear that the increased administrative costs associated with actively managed accounts would be offset by higher investment returns.³⁵

31. See Diamond, *supra* note 4, at 54.

32. See GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 26 (noting that "[i]ndividual account structures with lower administrative costs are often associated with more restricted investment choices and more centralized management, while increasing individual choice and decentralizing the management structure could result in increased costs").

33. See Mitchell, *supra* note 20, at 427-29; see also GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 3, 14-15 (estimating annual administrative costs ranging from around 0.1% for centralized system with limited investment choices and services to 2% or 3% for decentralized system with more extensive investment choices and services); Estelle James et al., *Mutual Funds and Institutional Investments: What Is the Most Efficient Way to Set Up Individual Accounts in a Social Security System?*, in ADMINISTRATIVE ASPECTS, *supra* note 22, at 120 (estimating that asset management costs in system of "constrained choice" could be kept at or below 0.65% of asset value); Sylvester J. Schieber & John B. Shoven, *Administering a Cost-Effective National Program of Personal Security Accounts*, in ADMINISTRATIVE ASPECTS, *supra* note 22, at 56 tbl. 2.4 (showing total administrative fees charged by selected large mutual fund companies in 1998 ranging from 0.19% to 0.77% of asset value).

34. See Peter Diamond, *Administrative Costs and Equilibrium Charges with Individual Accounts*, in ADMINISTRATIVE ASPECTS, *supra* note 22, at 146 (noting that "a critical question is what level of services would be a political equilibrium").

35. See GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 24 (noting that "[m]any actively managed investment options have not been able to generate higher returns than broad market indexes"); James et al., *supra* note 33, at 111 (noting that "[i]f higher costs led to higher returns, they would be worth incurring. However, a large literature indicates that this is not the case . . ."); see also Estelle James et al., *Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective*, in NEW IDEAS ABOUT OLD AGE SECURITY: TOWARD SUSTAINABLE PENSION SYSTEMS IN THE 21ST CENTURY 254, 297 (Robert Holzmann & Joseph E. Stiglitz eds., 2001) [hereinafter NEW IDEAS ABOUT OLD AGE SECURITY] (noting

High administrative costs would be especially burdensome for small accounts. For a worker who earns an average wage and retires at the normal retirement age after a full career, the accumulated balance in a personal account is likely to be relatively modest.³⁶ One way to mitigate this problem would be to calculate administrative costs for all accounts based on a uniform percentage of asset value, thereby cross-subsidizing small accounts.³⁷ Alternatively, it might be possible to impose a cap on administrative costs, though enforcement of such a cap might prove difficult.³⁸

As an example of a low-cost, "no-frills" retirement plan, consider the Thrift Savings Plan (TSP), a defined contribution plan for federal employees.³⁹ The TSP is administered by the Federal Retirement Thrift Investment Board, an independent federal agency. Contributions are collected through payroll deductions and held in trust for participants. Individual participants allocate their contributions within a limited range of passive index funds that are managed by private investment managers selected in a competitive bidding process.⁴⁰

The TSP demonstrates that a retirement system with personal accounts can achieve substantial diversification at a low administrative cost.⁴¹ Some

that constraints on investment choices are predicated on assumption "that the judgement of many workers about the relationship between fund performance and fees is imperfect, and that cost saving, which is certain, should take precedence over workers' expectations about returns, which are highly uncertain, in a mandatory scheme").

36. Assuming annual contributions equal to two percent of wages and annual administrative costs equal to 0.1% of asset value, an average-wage male worker born in 1984 who retires at the end of a forty-five-year career may expect to accumulate an account balance of \$125,430 (in 1998 dollars). See GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 22-23. If annual administrative costs rise to two percent, the expected balance drops to \$75,995. See *id.* at 23.

37. See PANEL ON PRIVATIZATION, *supra* note 15, at 65. Alternatively, the government could provide an explicit subsidy for small accounts in the form of "matching contributions" for low earners; because it would render redistribution more transparent, this approach might prove politically less palatable than a schedule of uniform charges based on asset value. See *id.*; see also Goldberg & Graetz, *supra* note 22, at 22 (suggesting that portion of administrative costs might be financed from general revenues).

38. See Howell E. Jackson, *Discussion, in* FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 329, 342; Schieber & Shoven, *supra* note 33, at 65 (suggesting that management fees be capped at one percent of asset value "or some other reasonable level").

39. See 5 U.S.C. §§ 8431-8440e (1994) (establishing Thrift Savings Plan).

40. The TSP currently offers its participants a choice of the following three index investment funds: a government securities fund, a common stock fund, and a fixed income fund. See FED. RET. THRIFT INV. BD., THRIFT SAVINGS PLAN: GUIDE TO TSP INVESTMENTS 2-3 (1998); GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 25. Recently, the TSP's investment board announced plans to add the following two additional funds: a small capitalization fund and an international stock fund. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 34.

41. See Mitchell, *supra* note 20, at 439 (citing TSP as example of "scale economies feasible in a centrally managed, large defined-contribution pension plan that restricts its investment choices to a very small set of indexes"). By one estimate, the annual administrative costs

observers, however, point out that the TSP is a special case and doubt whether its success can be replicated in a comprehensive national retirement system.⁴² In part, the TSP functions well because it is essentially a single-employer plan with ready access to centralized recordkeeping and services. The federal government, as employer and plan sponsor, distributes forms and other materials, educates employees about investment choices, and ensures timely and accurate transmission of information concerning payroll deductions and other matters.⁴³ In addition, TSP participants tend to be older, change jobs less frequently, and earn higher average wages than the general work force covered by Social Security.⁴⁴ Finally, in terms of the number of accounts and aggregate asset value, the TSP does not approach the size of a national system.⁴⁵

Most privatization proposals contemplate a single set of investment options – either broad or narrow – for all participants. It would be possible, however, to design a hybrid system with two tiers, such as a basic, low-cost tier offering a limited range of passively managed index funds, coupled with a supplemental tier offering a broader range of actively managed investment options and services at a correspondingly higher cost.⁴⁶ The constrained basic tier would meet the needs of participants seeking a low-cost investment vehicle with limited options and few services, while the more flexible supplemental tier would allow participants, at their own expense, to pursue investment strategies more closely tailored to their own risk and return preferences. Arguably, a two-tier approach might balance competing objectives and concerns more effectively than any single set of investment options.⁴⁷ Moreover, a two-tier arrangement could encourage financial intermediaries to compete

of a similar system for workers covered by social security would be around 0.2-0.3% of asset value. *See id.* at 448; *cf.* Goldberg & Graetz, *supra* note 22, at 21 (estimating annual administrative costs at 0.3-0.5% of asset value).

42. *See* Francis X. Cavanaugh, *Discussion, in* FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 319, 323 (arguing that TSP demonstrates feasibility of centralized trust fund investment but is "not a proper model for individual investment accounts in the Social Security program").

43. *See* GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 7 n.10 (noting that separate government agency "provides detailed recordkeeping and software development and maintains an office to provide service to participants"); Cavanaugh, *supra* note 42, at 524-25.

44. *See* GAO, ADMINISTRATIVE COSTS, *supra* note 30, at 17.

45. In 1995, the TSP had around two million participants and around \$36 billion in assets. *See* Mitchell, *supra* note 20, at 439 & 441 tbl. 10.13.

46. Alternatively, all participants might initially be assigned to the basic tier until their account balances reached a certain level and then be permitted to move into the supplemental tier. *See* GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 35.

47. *See* Goldberg & Graetz, *supra* note 22, at 25-26 (arguing that two-tier approach might help to keep costs low to reduce "marketing abuses," and to mitigate "pressure to impose detailed regulations"); *see also* John B. Shoven, *Introduction, in* ADMINISTRATIVE ASPECTS, *supra* note 22, at 3 (suggesting that basic government-sponsored plan would "discipline the private-sector offerings").

for large accounts by offering a broad range of sophisticated investment options and services.⁴⁸

In a two-tier system, the question arises whether participants should be required to maintain a specified account balance in the basic tier before becoming eligible to invest in the supplemental tier. Such a requirement would encourage participants to hold some minimum level of assets in relatively safe investment vehicles and would limit the availability of more aggressive risk-taking to those who could afford to sustain substantial losses. Thus, a mandatory basic tier would guard against excessively risky investment behavior as well as the related problem of a potential government bail-out for participants with poor investment outcomes.⁴⁹

As a practical matter, however, a two-tier system might generate new pressures that could undermine the long-term stability of the system. If the basic tier were mandatory up to a specified account balance, the system would be open to criticism on the ground that it would create two classes of participants. Those with large accounts would have access to the supplemental tier with its higher level of services; they might also earn higher returns associated with riskier investments or superior management. Participants with small accounts would be relegated to the basic tier with its constrained investment options and more limited services; they might receive lower investment returns, albeit with less risk. As a result, there might be considerable pressure to relax or to eliminate restrictions on access to the supplemental tier. Support for a mandatory basic tier could further be eroded by the widespread tendency to underestimate the level of assets needed to provide an adequate stream of retirement income.⁵⁰

If the supplemental tier became freely available to all participants, the basic tier might eventually function simply as a default setting for participants who fail to select a different investment option. There would be no assurance, however, that those who opt out of the basic tier would be better off as a result. Ultimately, the goal of ensuring some minimally adequate level of retirement income for all participants may require mandatory constraints on investment options for all personal accounts, regardless of size. If some participants wish to pursue high-risk investment strategies with their own non-retirement assets, they would be able to do so without increasing the cost of the national retirement system.

48. See ADVISORY COUNCIL REPORT, *supra* note 3, at 73 (predicting "explosion of marketing efforts" as result of privatization).

49. See *infra* notes 83-93 and accompanying text (discussing government guarantees).

50. See Hugh Heclo, *A Political Science Perspective on Social Security Reform*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 65, 85 & n.12 (noting that "wealth illusion" may cause individuals systematically to underestimate level of saving needed to fund retirement).

2. Regulatory Response

Although offering a broad range of investment options would maximize individual choice, it might also create a need for increased government regulation to monitor financial intermediaries and to protect individual participants. Under some proposals, various types of financial intermediaries – including banks, insurance companies, investment companies, and perhaps registered broker-dealers – would be eligible to manage personal accounts.⁵¹ Identifying and monitoring such a large number of diverse financial intermediaries would pose a daunting regulatory challenge. In response, it might be possible to designate a limited number of qualified providers with strong capitalization and compliance records.⁵² Limiting entry might well provoke opposition from excluded providers. More importantly, however, it would narrow the scope of the problem without addressing the fundamental issues of oversight and enforcement for qualified providers.

One possible approach would be to build on existing regulatory systems to implement separate standards for each type of financial intermediary (e.g., banks, insurance companies, investment companies). This "functional" approach, however, would generate a motley patchwork of different standards and structures for various types of providers.⁵³ To ensure more uniform and consistent standards, it might be preferable to enact overarching legislation, administered by one or more federal agencies, applicable to all providers acting as managers of personal accounts.⁵⁴

If individual participants are to assume responsibility for making choices that affect their retirement income security, they must have at least a rudimen-

51. Cf. ERISA § 3(38), 29 U.S.C. § 1002(38) (1994) (requiring that "investment manager" responsible for managing plan assets must be bank, insurance company, or investment adviser registered under Investment Advisors Act of 1940).

52. The number of qualified providers might be limited, at least initially, to no more than fifty. See Jackson, *supra* note 38, at 341 (noting that limiting number of qualified providers would "ease supervision and reduce the likelihood of compliance problems"). The optimal number and range of qualified providers might increase over time with the growth of assets in the system. See James et al., *supra* note 33, at 118 (noting that entry might initially be limited to firms offering passive index funds selected through competitive bidding process and later opened up to active managers who agreed to operate within specified cost constraints); see also GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 26 (noting that in Chile, workers may select from twelve or more qualified pension funds).

53. See Jackson, *supra* note 38, at 340-41; Roberta S. Karmel, *The Challenge to Financial Regulators Posed by Social Security Privatization*, 64 BROOK. L. REV. 1043, 1075-76 (1998) (noting problems with functional approach).

54. See Jackson, *supra* note 38, at 341. By analogy, ERISA entrusts oversight responsibility for private pension plans to various agencies, including the Department of Labor's Pension and Welfare Benefits Administration, the Treasury Department, and the Pension Benefit Guaranty Corporation. See GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 19.

tary understanding of basic financial concepts, investment strategies, and goals of retirement saving.⁵⁵ At present, however, "most Americans know little about managing personal finances and their choices reflect this ignorance."⁵⁶ Accordingly, a massive campaign of investor education would be necessary to achieve even a minimally adequate level of financial literacy. The wider the range of available investment options, the greater the need for investor education concerning risk and return characteristics of particular types of investments and the role of diversification.⁵⁷ In a system with a broad range of investment options, increased competition among qualified providers also might require special measures to protect participants from fraud.⁵⁸ It remains unclear how the need for investor education would be met and who would bear the costs.⁵⁹ Furthermore, while efforts at investor education might be helpful, their efficacy cannot be guaranteed.⁶⁰

To mitigate the risk of harm to individual participants from inappropriate investment decisions, it might be necessary to impose a fiduciary duty on qualified providers to steer participants toward "suitable" investment options.⁶¹

55. See GAO, *CAPITAL MARKETS*, *supra* note 12, at 50-63 (discussing need for investor education).

56. B. Douglas Bernheim, *Financial Illiteracy, Education, and Retirement Saving*, in *LIVING WITH DEFINED CONTRIBUTION PENSIONS: REMAKING RESPONSIBILITY FOR RETIREMENT* 38, 43 (Olivia S. Mitchell & Sylvester J. Schieber eds., 1998); see also GAO, *CAPITAL MARKETS*, *supra* note 12, at 59 (reporting that "over half of all Americans do not know the difference between a stock and a bond," and less than half of mutual fund investors correctly understand purpose of diversification).

57. See GAO, *CAPITAL MARKETS*, *supra* note 12, at 60-63.

58. See *id.* at 61 (noting that broad range of investment options would provide "opportunities for fraud and sales practice abuses"); see also James et al., *supra* note 33, at 119 (noting that "while information is imparted by marketing, investment companies and brokers have a clear incentive to impart misleading information").

59. See GAO, *ADMINISTRATIVE COSTS*, *supra* note 30, at 22 (noting that government, employers, and investment managers might each bear some responsibilities and costs, depending on system design); see also Schieber & Shoven, *supra* note 33, at 55 (noting that "giving workers control or an active role in the investment of their retirement savings is likely to spur . . . more financial education").

60. See Bernheim, *supra* note 56, at 64. See generally James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105 (1998); James et al., *supra* note 35, at 281 (noting that "an entire generation of workers may pass through the system before low-cost, high-performing funds are identified"). This situation is exacerbated by inexperienced investors' difficulty in understanding financial information.

61. See Jackson, *supra* note 38, at 342. Under ERISA's "exclusive benefit rule," a plan fiduciary must discharge its duties solely in the interests of plan participants and beneficiaries and for the exclusive purpose of providing benefits to them. See ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (1994). The implementing regulations specify factors that a fiduciary must consider in making investment decisions. See 29 C.F.R. § 2550.404a-1(b)(2) (2000); cf.

Here, the fiduciary standards of ERISA could serve as a useful starting point.⁶² ERISA gives employers a strong incentive to provide investor education in order to meet their fiduciary duties.⁶³ Under a safe harbor for "self-directed" accounts, however, a plan sponsor can avoid liability for losses arising from poor investment decisions by giving participants control over their own accounts.⁶⁴ To come within the safe harbor, the plan must offer participants a choice of at least three alternative investment options consisting of diversified funds with materially different risk and return features.⁶⁵ Participants also must receive adequate information concerning the risk and return characteristics and investment objectives of the available options.⁶⁶ Within these general parameters, participants enjoy considerable latitude in allocating their account balances among particular funds.⁶⁷

Imposing fiduciary duties may mitigate investment risks for individual participants. However, such regulation may prove quite costly and may dampen competition among qualified providers.⁶⁸ Ultimately, allowing wide freedom of choice within a framework of strict fiduciary duties may prove

Deborah M. Weiss, *The Regulation of Funded Social Security*, 64 BROOK. L. REV. 993, 1016 (1998) (referring to ERISA's "inadequate fiduciary rules").

62. See KELLY A. OLSEN & DALLAS L. SALISBURY, *INDIVIDUAL SOCIAL SECURITY ACCOUNTS: ISSUES IN ASSESSING ADMINISTRATIVE FEASIBILITY AND COSTS* 31 (Employee Benefit Research Inst., Issue Brief No. 203, 1998) (noting that ERISA "portends a large role for government regulation" of personal accounts).

63. See Mitchell, *supra* note 20, at 435 (noting that employers who sponsor 401(k) plans make substantial expenditures for investor education and periodic account statements to participants due to concerns about potential fiduciary liability).

64. See ERISA § 404(c), 29 U.S.C. § 1104(c) (1994); 29 C.F.R. § 2550.404c-1 (2000) (implementing regulations); see also PAMELA PERUN & C. EUGENE STEUERLE, *DECONSTRUCTING ERISA* 14-15 (Brookings Inst., Stanford Inst. for Econ. Policy Research, & TIAA-CREF Inst., Conference on Pub. Policies and Private Pensions, 2000) (manuscript on file) (noting that in 1997, 404(c) plans accounted for "65% of the assets of profit-sharing plans and almost 70% of all active participants"); Gordon P. Goodfellow & Sylvester J. Schieber, *Investment of Assets in Self-Directed Retirement Plans*, in *POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY* 67, 72 (Michael S. Gordon et al. eds., 1997) (describing employers' movement toward 404(c) plans as "further effort to pass on the risk of negative market performance to the plan participants"); Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 632-36 (2000) (discussing 404(c) plans).

65. See 29 C.F.R. § 2550.404c-1(b)(3) (2000).

66. See GAO, *CAPITAL MARKETS*, *supra* note 12, at 52-53 (describing disclosure rules).

67. For example, an employee may choose to direct investments to a specific investment category within a diversified pool (e.g., small capitalization stocks or international stocks). See Pozen & Kimpel, *supra* note 24, at 374.

68. See GAO, *IMPLEMENTATION ISSUES*, *supra* note 13, at 29 (noting that in Chile, "fund managers tend to hold portfolios of assets that are similar to the ones held by their competitors," thereby limiting "the variety of choice and earnings potential of the privately managed funds").

more costly and intrusive than direct constraints on the available investment options.⁶⁹

3. Investment Risk

A broad range of investment options increases the risk that some participants will have inadequate savings at retirement. Some participants may receive relatively low returns as a result of conservative investment decisions, while others may incur large losses due to excessive risk-taking. Even if markets perform well over the long term, different cohorts may earn dramatically different returns due to market fluctuations.⁷⁰ Those who happen to retire when the market has soared to new heights (or dived to new depths) would find themselves locked into unexpectedly high (or low) levels of income during retirement.⁷¹ As a result of poor investment decisions or simple bad luck, some individuals would undoubtedly end up with inadequate balances in their personal accounts at retirement.

Allocation of investment assets is likely to play a crucial role in determining the adequacy of retirement income. Despite the shift toward increased individual responsibility in 401(k) plans, there is little consensus concerning how well individual 401(k) participants manage their portfolios. Many observers have expressed concern that 401(k) participants are likely to wind up with inadequate retirement savings because of excessively conservative investments or lack of adequate diversification.⁷² Influenced perhaps by the recent stock market boom, however, participants have invested an increasing percentage of their 401(k) assets in equities.⁷³ Some observers warn that

69. See Jackson, *supra* note 38, at 345 ("As a practical matter, the more . . . constraints one imposes, the more sensible it would be to rely on an individual account-style approach where the government itself provides the investment choices."); see also Peter A. Diamond, *Macroeconomic Aspects of Social Security Reform*, in 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1, 51 (William C. Brainard & George L. Perry eds., 1997) (noting that "tight regulatory structure [might] forfeit some of the political insulation that comes from individual portfolio choice").

70. See GAO, CAPITAL MARKETS, *supra* note 12, at 39-40.

71. See Lawrence H. Thompson, *Individual Uncertainty in Retirement Income Planning under Different Public Pension Regimes*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 113, 121-29.

72. See STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS: THE FIRST HUNDRED YEARS 249 (1997) (noting that "most participants are notoriously conservative investors"); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1540 (1997) (noting that "the investment strategy selected for defined contribution funds is often far too conservative"). Investments in 401(k) plans may be unduly concentrated in employer stocks. See Vickie L. Bajtelsmit & Jack L. VanDerhei, *Risk Aversion and Pension Investment Choices*, in POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY, *supra* note 64, at 55 (noting that "[n]ot only is the pension underdiversified, but the employee has both human and financial capital tied to the success or failure of a single business").

73. See James M. Poterba & David A. Wise, *Individual Financial Decisions in Retirement Saving Plans and the Provision of Resources for Retirement*, in PRIVATIZING SOCIAL SECURITY,

401(k) participants may now be investing too heavily in equities, potentially exposing themselves to severe repercussions in the event of a sharp stock market decline.⁷⁴ Others maintain that 401(k) participants have adapted well to their new responsibilities and are investing in a manner that conforms to reasonable expectations.⁷⁵

Because 401(k) participants tend to have more education and higher incomes than other workers, generalizations based on the 401(k) investment experience are hazardous at best.⁷⁶ Moreover, in making current asset allocation decisions, 401(k) participants presumably take their expected future social security benefits into account. Without those benefits, participants might invest their 401(k) balances less aggressively.⁷⁷ Thus, projections based on existing 401(k) asset allocations may overstate the likely investment returns on personal accounts.⁷⁸

Demographic and socioeconomic factors may also play an important role in influencing asset allocation. For example, to the extent that wealthier households tend to have higher risk tolerance than poorer households, broad investment options may exacerbate existing wealth discrepancies.⁷⁹ Similarly,

supra note 4, at 373 (noting that in 1995, around one-half of 401(k) assets were invested in equities); James M. Poterba et al., *401(k) Plans and Future Patterns of Retirement Saving*, 88 AM. ECON. REV. 179, 181 (1998).

74. See, e.g., ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 218 (2000) ("Many participants no doubt put virtually all of their pension funds into the stock market."); see also *id.* at 218 n.11 (noting that percentage of TIAA-CREF participants who allocate one hundred percent of their contributions to stock increased from around three percent in 1986 to around twenty-two percent in 1996).

75. See, e.g., Robert L. Clark et al., *Making the Most of 401(k) Plans: Who's Choosing What and Why?*, in *FORECASTING RETIREMENT NEEDS AND RETIREMENT WEALTH* 95, 127 (Olivia S. Mitchell et al. eds., 2000) (suggesting that 401(k) experience should "dispel some of the concerns associated with individual accounts").

76. Even among 401(k) participants, the level of financial literacy may be unacceptably low. See GAO, *CAPITAL MARKETS*, *supra* note 12, at 59 (finding that "it is clear that among those who save through their company's retirement programs or on their own, there are large percentages of the investing population who do not fully understand what they are doing"); Jefferson, *supra* note 64, at 635 (noting that "it is not uncommon for plan participants to have inflated opinions about their investment expertise").

77. See GEN. ACCOUNTING OFFICE, *SOCIAL SECURITY REFORM: IMPLICATIONS FOR PRIVATE PENSIONS* (GAO/HEHS-00-187), REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS 30-31 (2000); CORI E. UCCELLO, *401(k) INVESTMENT DECISIONS AND SOCIAL SECURITY REFORM* 5 (Ctr. for Ret. Research at Boston Coll., Working Paper No. 2000-04, 2000).

78. See UCCELLO, *supra* note 77, at 5; see also Gregory, *supra* note 17, at 324 (noting uncertainty as to whether participants would be "more aggressive" or "more risk-adverse" in their investment choices).

79. See Bajtelsmit & VanDerhei, *supra* note 72, at 55. For some individuals, particularly those with lower incomes, the "potential disutility from losing even a small amount of value in

evidence that women tend to invest more conservatively than men may imply gender disparities in retirement income.⁸⁰ While income and education appear to be better predictors of investment behavior than race, some observers express concern that minorities may tend to choose investments with relatively low levels of risk and correspondingly low returns.⁸¹ Thus, differences in risk preferences, combined with the trend toward greater individual investment responsibility, may translate into lower retirement income for those groups most "at risk," including low-income workers, women, and minorities.⁸²

To mitigate individual investment risks, the government might well be called upon to guarantee a minimum account balance or rate of return on accounts.⁸³ Some privatization proposals attempt to sidestep the problem of individual risk by promising participants the higher of current Social Security benefits or benefits attributable to their personal accounts.⁸⁴ If contributions to personal accounts were limited to two percent of covered payroll, partici-

their assets outweighs the added potential utility from substantially larger gains." Goodfellow & Schieber, *supra* note 64, at 73.

80. See Richard P. Hinz et al., *Are Women Conservative Investors? Gender Differences in Participant-Directed Pension Investments*, in POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY, *supra* note 64, at 99 (finding that women tend to be more risk averse than men based on survey of TSP participants); cf. Clark et al., *supra* note 75, at 125-27 (finding little difference in 401(k) investment patterns by gender); Leslie E. Papke, *How Are Participants Investing Their Accounts in Participant-Directed Individual Account Pension Plans?*, 88 AM. ECON. REV. 212, 215 (1998) (same).

81. See Bernheim, *supra* note 56, at 47 ("Differences based on gender and race are statistically significant, even holding other variables (such as education and earnings) constant.").

82. See Bajtelsmit & VanDerhei, *supra* note 72, at 62 ("If certain groups, particularly those that already have lower income and wealth, exhibit different risk preferences, income and wealth differentials in retirement will be even greater."); Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effect on Women, Minorities, and Lower-Income Workers*, 65 MO. L. REV. 341, 352-66, 402 (2000).

83. See PANEL ON PRIVATIZATION, *supra* note 15, at 55 (noting that "there will be calls for the government to insure promised returns"); Stephen G. Kellison & Marilyn Moon, *New Opportunities for the Social Security System*, in PROSPECTS FOR SOCIAL SECURITY REFORM, *supra* note 9, at 72-73. For example, such guarantees are a feature of the privatized system in Chile. See Peter A. Diamond & Salvador Valdés-Prieto, *Social Security Reforms*, in THE CHILEAN ECONOMY: POLICY LESSONS AND CHALLENGES 304-05 (Barry P. Bosworth et al. eds., 1994).

84. See Andrew B. Lyon & John L. Stell, *Analysis of Current Social Security Reform Proposals*, 53 NAT'L TAX J. 473, 474-79 (2000) (discussing Archer-Shaw "Social Security Guarantee Plan"). The Archer-Shaw plan would guarantee social security benefits at their existing level, but would reduce them dollar-for-dollar by the annuitized value of personal accounts. See *id.*; cf. MARTIN FELDSTEIN & ANDREW SAMWICK, TWO PERCENT PERSONAL RETIREMENT ACCOUNTS: THEIR POTENTIAL EFFECTS ON SOCIAL SECURITY TAX RATES AND NATIONAL SAVING 1-3 (Nat'l Bureau of Econ. Research, Working Paper No. 6540, 1998) (outlining similar plan with reduction limited to seventy-five percent of value of personal accounts).

pants would have to earn extremely high returns to outperform social security in the near term. Thus, the principal effect of such Social Security guarantees may be to infuse general revenues into the existing system while offering a lucrative new source of business for the mutual fund industry.⁸⁵

From the perspective of the individual participant, Social Security guarantees combined with personal accounts have the effect of altering the composition of benefits.⁸⁶ If expected stock market returns are realized, an increasing proportion of retirement benefits would be funded from personal accounts over time. Substituting personal account benefits for Social Security benefits, particularly among high and moderate earners, might eventually weaken support for the existing collective defined benefit system.⁸⁷ Perhaps the greater risk is that expected market returns could fail to materialize and the cost of residual government guarantees could exceed unfunded liabilities under the existing system.⁸⁸ The government might come under considerable pressure to reduce such guarantees to avoid shifting the risk of lower-than-expected returns to younger and future workers in the form of higher taxes.⁸⁹

Government guarantees to compensate individual losses may encourage excessive risk taking.⁹⁰ This problem could be reduced by having the government guarantee only the return on a "standardized" portfolio – e.g., the return

85. Under the Archer-Shaw plan, contributions to personal accounts would be funded from general revenues (based on a combination of projected budget surpluses and additional borrowing) through an annual income tax credit equal to two percent of covered payroll. See Lyon & Stell, *supra* note 84, at 477.

86. See *id.* at 498 (noting that "the total benefit remains the same, but the composition would change to include the private account annuity").

87. See Alicia H. Munnell, *Reforming Social Security: The Case Against Individual Accounts*, 52 NAT'L TAX J. 803, 811 (1999) (noting that high and moderate earners "would lose a large percentage of their Social Security benefits under the offset provision").

88. See KENT SMETTERS, *THE DESIGN AND COST OF PENSION GUARANTEES 1* (Brookings Inst., Stanford Inst. for Econ. Policy Research, & TIAA-CREF Inst., Conference on Pub. Policies and Private Pensions, 2000) (manuscript on file) (noting that under one recent proposal, "the unfunded liability associated with [a] minimum benefit guarantee could actually be larger than Social Security's existing unfunded liability"); Lyon & Stell, *supra* note 84, at 506 (noting that, despite large infusion of general revenues, low returns could cause actuarial imbalance under Archer-Shaw plan).

89. See Munnell, *supra* note 87, at 811 (noting that benefit reductions could "significantly hurt future retirees who have not been lucky enough to participate in the surplus bonanza"). See generally Kent Smetters, *Three Key Design Issues in Analyzing the Trust Fund Investment Policy*, 52 NAT'L TAX J. 531 (1999) (discussing allocation of intergenerational risk if realized returns differ from expected returns).

90. A government guarantee would effectively increase the expected return from risky investments. See STAFF OF JOINT COMM. ON TAXATION, *ANALYSIS OF ISSUES RELATING TO SOCIAL SECURITY PRIVATE ACCOUNTS* 61-62 (JCX-14-99) (1999) (noting that in extreme case, "the risky investment actually has no downside risk, since the government will make up all the losses").

that an individual participant would have earned by investing in a broadly diversified equity index and corporate bond fund.⁹¹ Individual participants would thus bear the risk of deviating from the standardized portfolio. This approach is problematic, however, because it ignores the risks inherent in the standardized portfolio. Assumptions concerning historical real rates of return on equities may prove unduly optimistic, especially given current high stock market valuations and projected low rates of economic growth.⁹² As a practical matter, combining a guarantee of existing Social Security benefits with personal accounts is unlikely to prove sustainable.⁹³ The reluctance of privatization proponents to address explicitly the cost of government guarantees may reflect the political controversy surrounding this issue.

4. Political Risk

In theory, the benefits of a diversified investment portfolio could be achieved either through a centralized trust fund administered directly by the government⁹⁴ or through a decentralized system of personal accounts controlled by individual participants. A centralized trust fund poses the political risk that accumulated funds may be used to mask deficits in the rest of the federal budget. An important function of personal accounts, according to proponents, is that they put retirement funds beyond the reach of the government and thereby remove the temptation to use those funds to finance deficit spending.⁹⁵ In one sense, then, personal accounts may be viewed as a form of public fiscal discipline.

91. See Martin Feldstein et al., *The Transition to Investment-Based Social Security When Portfolio Returns and Capital Profitability Are Uncertain*, in RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 41, 69 (John Y. Campbell & Martin Feldstein eds., 2001).

92. See PETER A. DIAMOND, WHAT STOCK MARKET RETURNS TO EXPECT FOR THE FUTURE? 2 (Ctr. for Ret. Research at Boston Coll. ed., 1999). Based on historical simulations, critics of trust fund investment have pointed out that Social Security returns might have been lower in approximately one out of four intervals examined had the government invested in a diversified portfolio of equities rather than in an all-bond portfolio. See Thomas E. MaCurdy & John B. Shoven, *Asset Allocation and Risk Allocation: Can Social Security Improve Its Future Solvency Problem by Investing in Private Securities?*, in RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM, *supra* note 91, at 18; *id.* at 27 (noting that "[t]he extra risks of stocks translate directly into riskier future benefits and taxes").

93. See *supra* notes 86-89 and accompanying text (discussing government guarantees). A more realistic outcome might be a minimum floor of guaranteed benefits that would provide a safety net for those who would otherwise be near the poverty level. See ADVISORY COUNCIL REPORT, *supra* note 3, at 30-31 (describing flat benefit under PSA plan).

94. See ADVISORY COUNCIL REPORT, *supra* note 3, at 25-27 (proposing retention of existing Social Security system, with up to forty percent of trust funds eventually to be invested in stock market).

95. See Mariger, *supra* note 6, at 796 (suggesting that "if political constraints make it impossible to prefund in government accounts, then prefunding in private accounts would be a viable option").

Shifting control of funds from the government to individual participants, however, may replace one type of political risk with another. To the extent that participants view their personal accounts as merely another form of tax-favored private savings, they may expect to be able to tap into those savings for specified purposes (e.g., to purchase a home, finance an education, or pay medical expenses) prior to retirement, as is presently allowed in the case of 401(k) plans.⁹⁶ The problem would be especially acute in a two-tier system because considerations of fairness would make it difficult to maintain restrictions on access to the basic tier (when the reasons for such restrictions would be strongest), while providing more lenient treatment for the supplemental tier.⁹⁷ Even if early access were allowed initially only in cases of hardship, it might prove politically impossible to resist demands for more general early access.⁹⁸ Failure to maintain restrictions on early access could compromise the financial security of individual participants and would seriously undermine the viability of a universal system of mandatory retirement savings.⁹⁹

Another type of political risk arises from the possibility of government interference in capital markets. In the case of a centralized system administered by the government, one concern is that the government might seek to influence corporate decision-making through the exercise of stock voting rights. This concern could be addressed by prohibiting the exercise of voting rights with respect to government-held stock¹⁰⁰ or by specifying fiduciary

96. See Thompson, *supra* note 71, at 132 (noting that existing law permits early withdrawals for home purchases and for medical or educational expenses, with result that "a substantial portion of what is set aside in individual retirement savings programs may be dissipated prior to retirement").

97. See STAFF OF JOINT COMM. ON TAXATION, *supra* note 90, at 33 (noting importance of prohibiting early access to funds); see also Leonard E. Burman et al., *Lump Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research*, 52 NAT'L TAX J. 553, 559 (1999) (noting that "it could be that precisely the households for whom pensions are most likely to represent additional saving are also the ones that are most likely not to retain that saving"); Dallas L. Salisbury, *Employers and Individuals Must Do More Today to Allow Retirement Tomorrow*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 95, 103 (noting that in 1990, "44 percent of the dollars paid in lump sum distributions [were] not saved for retirement").

98. See STAFF OF JOINT COMM. ON TAXATION, *supra* note 90, at 33 (noting that "if individuals view private accounts . . . as personal savings, or as supplements to other retirement income, they may be more opposed to restrictions on preretirement access to funds"); Heelo, *supra* note 50, at 85 (noting that "the political attraction of selling forced savings with the idea that 'it's your own money' . . . will make it more difficult in the long run to sustain such nest eggs for retirement").

99. See Gregory, *supra* note 17, at 324 (noting that optimistic assessments of boomer generation's retirement prospects assume little or no "leakage" from retirement plans).

100. See Theodore J. Angelis, *Investing Public Money in Private Markets: What Are the Right Questions?*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, at 287, 306-07; see

standards to ensure that voting rights be exercised solely to maximize share values.¹⁰¹ A related and more serious concern is that the government might use investment decisions as a means to reward (or to punish) certain firms or industries or as a means to advance (or to impede) certain fiscal, social, or foreign policy agendas.¹⁰²

In this respect, as in other matters of investment management, the experience with the TSP is illuminating. The TSP appears to have been successful in administering funds based solely on criteria of risk and return without regard to extraneous considerations.¹⁰³ Observers often attribute the TSP's success to the following combination of institutional safeguards: an independent board, a strategy of investing in passively managed index funds, and a strong commitment to political non-intervention.¹⁰⁴ It is not clear, however, whether the TSP's experience could be extrapolated to a much larger scale. The sheer size of the funds involved might make government interference both politically more tempting and financially more threatening.¹⁰⁵

In response to proponents of a system modeled on the TSP, critics point to the activities of state and local pension plans. Managers of such plans are sometimes perceived as pursuing politically-motivated investment strategies at the expense of optimal returns.¹⁰⁶ While managers of some state and local

also PANEL ON PRIVATIZATION, *supra* note 15, at 22 (recommending that trust fund investment be limited to between five and ten percent of stock of any single company).

101. See Angelis, *supra* note 100, at 307 (noting that under TSP, private managers exercise voting rights to maximize investment returns). Allowing investment managers to vote fund shares might also address the concern that large-scale passive investment would undercut the role of shareholder activism in monitoring corporate governance. See ALICA H. MUNNELL & PIERLUIGI BALDUZZI, INVESTING THE SOCIAL SECURITY TRUST FUNDS IN EQUITIES 14-15 (Am. Ass'n of Retired Pers., Pub. Policy Inst., Paper No. 9802, 1998) (noting that "studies suggest that shareholder activism yields positive returns, although the evidence is inconclusive"); cf. Weiss, *supra* note 61, at 998 (noting that exclusive reliance on passive investment policy in funded system would create "significant risk of reducing . . . active investment below the acceptable level").

102. See Angelis, *supra* note 100, at 292; Goldberg & Graetz, *supra* note 22, at 22.

103. See Angelis, *supra* note 100, at 293 (noting that TSP has "successfully avoided the problems of social investing"); Alicia H. Munnell, *Introduction*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 2, 1, 19-20 (comparing TSP and state pension funds).

104. See ADVISORY COUNCIL REPORT, *supra* note 3, at 155 (statement of Edward M. Gramlich & Marc M. Twinney) (proposing system of personal accounts based on TSP model to minimize risk of "political interference in the operations of private business"); cf. HENRY J. AARON & ROBERT D. REISCHAUER, COUNTDOWN TO REFORM: THE GREAT SOCIAL SECURITY DEBATE 111 (1998) (noting that "organizational reforms could all but eliminate the risk of political interference with investment decisions").

105. See P. Brett Hammond & Mark J. Warshawsky, *Investing Social Security Funds in Stocks*, 13 BENEFITS Q. 52, 58 (1997) (projecting that centralized trust fund investments could amount to five percent of total U.S. equities in 2020).

106. See Olivia S. Mitchell & Ping-Lung Hsin, *Public Pension Governance and Perfor-*

pension plans have undoubtedly engaged in such behavior, other observers take a more optimistic view, noting the "limited extent to which social or political considerations affect the performance of state and local pension funds."¹⁰⁷

The risk of political interference in stock investments cannot be eliminated entirely. Even the strongest safeguards would remain subject to the political risk of revision or repeal by subsequent legislation, and the government can always influence corporate behavior through direct regulation. By comparison, the potential economic harm from government interference through selection of investment managers or portfolio choices is likely to be relatively attenuated. Even a decentralized system of personal accounts would not necessarily be immune from government control.¹⁰⁸ Tax incentives and penalties, as well as rules governing the treatment of accumulations and withdrawals, could be used by the government to influence the investment behavior of individual participants. These measures might prove politically controversial, although perhaps no more so than an attempt to dismantle institutional investment safeguards. Ultimately, assessing the risk of government interference is "a matter of political prediction and, as such, inherently debatable."¹⁰⁹

C. Annuitization

The current defined benefit system protects beneficiaries against the risk of outliving their retirement resources by providing inflation-adjusted, mandatory annuities. By contrast, a defined contribution system would raise issues concerning how much choice individuals should have in structuring withdrawal of their personal accounts. Left to their own devices, it is unclear whether individuals would choose an adequate level of annuitization. The existing annuity market is extremely thin, due in part to problems of adverse selection, and the cost of annuities tends to be correspondingly high compared to the stream of annuity payments.¹¹⁰ Voluntary annuitization would exacer-

mance, in *THE ECONOMICS OF PENSIONS* 92, 109 (Salvador Valdés-Prieto ed., 1997). See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

107. ALICIA H. MUNNELL & ANNIKA SUNDÉN, INVESTMENT PRACTICES OF STATE AND LOCAL PENSION FUNDS: IMPLICATIONS FOR SOCIAL SECURITY REFORM 35 (Ctr. for Ret. Research at Boston Coll., Working Paper No. 1999-01, 1999); see *id.* at 3 (noting that "[t]oday, public plans appear to be performing as well as private plans").

108. See AARON & REISCHAUER, *supra* note 104, at 113.

109. Jackson, *supra* note 38, at 331.

110. See James M. Poterba & Mark J. Warshawsky, *The Costs of Annuitizing Retirement Payouts from Individual Accounts*, in *ADMINISTRATIVE ASPECTS*, *supra* note 22, at 180 (noting that for sixty-five-year-old male annuitant, based on general population mortality tables, expected present value of annuity payments is approximately eighty-five percent of purchase price); see also generally Olivia S. Mitchell et al., *New Evidence on the Money's Worth of Individual Annuities*, 89 AM. ECON. REV. 1299 (1999).

bate problems of adverse selection and potentially place at risk long-lived individuals with the greatest need for annuitization. Just as some form of mandatory savings is considered desirable to ensure an adequate level of resources at retirement, some level of mandatory annuitization may be desirable to ensure an adequate level of income through the retirement period.

A centralized system of personal accounts administered by the government might offer a low-cost means of providing mandatory annuities. Indeed, some form of government-sponsored annuities may be necessary for participants with small accounts because annuitizing large numbers of such accounts could prove uneconomical for private insurers.¹¹¹ The simplest alternative would make use of the existing system to annuitize personal accounts.¹¹² Upon retirement, individual participants would transfer the balance in their accounts to the Social Security Administration in exchange for additional annuity benefits based on the value of their accounts. The government would set the annuity amount by reference to the account balance and would accordingly bear the associated investment and mortality risks. Retired workers would receive a single monthly check reflecting the annuitized benefit from their personal accounts and the adjusted amount of their residual Social Security benefits.

Alternatively, the government could retain responsibility for processing benefit payments, but contract with private providers to offer annuities on a group basis.¹¹³ Such contracting out might be considered desirable because it would shift investment and mortality risks to the providers in the private sector. The use of private providers would also minimize the danger that the government might underprice annuities for current retirees and potentially shift some of the annuity risk to taxpayers generally.¹¹⁴ Even under a system

111. See GEN. ACCOUNTING OFFICE, SOCIAL SECURITY REFORM: IMPLICATIONS OF PRIVATE ANNUITIES FOR INDIVIDUAL ACCOUNTS (GAO/HEHS-99-160), REPORT TO THE RANKING MINORITY MEMBER, HOUSE COMM. ON WAYS AND MEANS 10 (1999) [hereinafter GAO, ANNUITIES] (quoting comment from insurance industry that it would be "inefficient and costly for insurers to provide annuities for individuals with small accounts"); GAO, IMPLEMENTATION ISSUES, *supra* note 13, at 41.

112. See GAO, ANNUITIES, *supra* note 111, at 10; PANEL ON PRIVATIZATION, *supra* note 15, at 69; Goldberg & Gractz, *supra* note 22, at 28.

113. See GAO, ANNUITIES, *supra* note 111, at 10 (noting that insurance companies could submit competitive bids to provide group annuities for cohort of retirees); PANEL ON PRIVATIZATION, *supra* note 15, at 69; Goldberg & Gractz, *supra* note 22, at 28. For example, the TSP solicits bids from private insurance companies to provide annuities to TSP participants. See Poterba & Warshawsky, *supra* note 110, at 185; see also Mark J. Warshawsky, *The Market for Individual Annuities and the Reform of Social Security*, 13 BENEFITS Q. 66, 75 (1997) (suggesting creation of "federal board of overseers of annuity providers" to administer national clearing house).

114. See Diamond, *supra* note 34, at 148 ("With private provision, the political outcome is more likely to be to accept the prices offered by the market.").

of privately provided annuities, however, the government would presumably continue to bear the residual risk that private providers would be unable to satisfy their annuity payment obligations.¹¹⁵ Without relatively tight supervision and regulation of providers, however, it would be impossible for the government to limit its potential liabilities.¹¹⁶

Allowing participants to purchase annuities from private providers would permit greater flexibility of payout options.¹¹⁷ Because the total administrative costs for annuities purchased in the private market could be quite high – as much as fifteen percent of the purchase price¹¹⁸ – a default system of government-sponsored annuities might be essential unless the annuity market could be made significantly more efficient. Although higher administrative costs would be borne directly by individual participants purchasing annuities from private providers, there might still be a need for government regulation to mitigate adverse selection and risk segmentation.¹¹⁹ Thus, the government might still play a significant role in ensuring that private annuity markets operated efficiently and fairly.

Although mandatory annuitization would help to reduce costs, it would also redistribute costs from shorter-lived to longer-lived groups. For example, sex-neutral mortality rates would favor women over men, on average.¹²⁰ An-

115. See PANEL ON PRIVATIZATION, *supra* note 15, at 69. Although insurance companies traditionally have been subject to regulation at the state level, the federal government's residual risk might give rise to regulation at the federal level. See *id.*; see also GAO, ANNUITIES, *supra* note 111, at 22-23 (discussing possibility of "federal guaranty" for annuities).

116. See GAO, ANNUITIES, *supra* note 111, at 23; Jan Walliser, *Regulation of Withdrawals in Individual Account Systems*, in NEW IDEAS ABOUT OLD AGE SECURITY, *supra* note 35, at 367, 386 (noting that regulation of private annuity providers would be necessary to reduce cost of implicit or explicit government guarantees).

117. See Goldberg & Graetz, *supra* note 22, at 29 (noting that wider range of annuity choices would permit alternative payment streams or provide funds for special needs such as caring for disabled children or early retirement); cf. Walliser, *supra* note 116, at 383 (noting competing goals of providing flexible payout options and allowing insurance markets to function properly).

118. See GAO, ANNUITIES, *supra* note 111, at 18-19; see also *supra* note 110 (noting potential cost of annuities).

119. See Goldberg & Graetz, *supra* note 22, at 13 (suggesting that private annuity providers "be required to provide all-comers annuities at the same age-based price"); Poterba & Warshawsky, *supra* note 110, at 179 (noting that system of personal accounts, coupled with mandatory annuitization, would "reduce adverse selection, although it would not eliminate it entirely because individuals would still presumably be allowed choices among annuity options and the age of settlement").

120. See GAO, ANNUITIES, *supra* note 111, at 15-16 (noting clear sex-based differences in mortality rates as well as potential correlation of mortality rates with "differences in income, race, education, and marital status"). The individual annuities market is not generally subject to mandatory use of unisex mortality tables. See *id.* The effect of differential mortality rates could be reduced by permitting purchase of a "life with term-certain" annuity. See *id.* at 17.

nity choices also raise sensitive issues concerning allocation of resources within the family. The existing system provides spousal and survivor benefits without any reduction in the primary worker's annuity. Because these benefits would not be replicated by a system of private annuities, it would be necessary to consider carefully the implications of expanded choice on the economic welfare of particularly vulnerable groups. In the case of married couples, mandatory annuities could contain a joint-and-survivor feature to avoid exacerbating the risk of poverty for widows in old age.¹²¹

The shift from the existing defined benefit system to a defined contribution system would also introduce new financial risks for participants. Depending on when an annuity is purchased, participants with identical personal account balances could receive significantly different annuity payments due to interest rate fluctuations.¹²² Some mechanism would be needed to mitigate the effect of changing interest rates, such as permitting retirees to purchase annuities in installments over several years.

Some proponents of privatization suggest that problems with the private annuities market can be managed by allowing participants to purchase variable rather than fixed annuities from the same qualified providers who managed their personal accounts prior to retirement.¹²³ Variable annuities are attractive because they would permit continued investment of personal accounts in the equities market, earning relatively high returns even after retirement. While variable annuities would maximize the expected return from personal accounts and might provide a hedge against inflation,¹²⁴ they would also increase the overall financial risk. Depending on the performance of the underlying investment portfolio, returns from variable annuities could fluctuate significantly from one year to the next.

121. See Karen C. Burke & Grayson M.P. McCouch, *The Impact of Social Security Reform on Women's Economic Security*, 16 N.Y.L. SCH. J. HUM. RTS. 375, 394-95 (1999); see also JEFFREY R. BROWN & MARK J. WARSHAWSKY, LONGEVITY-INSURED RETIREMENT DISTRIBUTIONS FROM PENSION PLANS: MARKET AND REGULATORY ISSUES 16-18 (Nat'l Bureau of Econ. Research, Working Paper No. 8064, 2001) (noting that 401(k) plans are required to provide qualified joint and survivor annuities only if they offer annuity payout option and that annuity payout options are generally not available).

122. See GAO, ANNUITIES, *supra* note 111, at 11 (noting effect of interest rate assumptions on annuity payments).

123. See MARTIN FELDSTEIN & ELENA RANGUELOVA, INDIVIDUAL RISK IN AN INVESTMENT-BASED SOCIAL SECURITY SYSTEM 4, 7 (Nat'l Bureau of Econ. Research, Working Paper No. 8074, 2001).

124. See Jeffrey R. Brown et al., *The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program*, in RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM, *supra* note 91, at 356-57; see also *id.* at 337-38 (noting "perennial question of why retirees are not more concerned about inflation protection").

Relying on variable annuities to produce the appropriate overall level of annuitization seems impractical. A series of poor investment returns would erode substantially the value of such annuities, exposing participants to the risk of inadequate retirement income or inflating the cost of residual government guarantees.¹²⁵ Projections based on the assumption that participants will purchase variable annuities at retirement understate the real cost of annuitization. If annuities were fixed in amount, the annuity provider could be expected to reduce its risks by investing in assets weighted more toward fixed-income assets than toward equities.¹²⁶ By analogy to variable annuities, programmed withdrawals also would pose substantial risks in terms of ensuring a steady stream of real annuity benefits.¹²⁷

Mandatory annuitization is in tension with the view of personal accounts as an accumulation of unrestricted personal wealth rather than an earmarked source of retirement income.¹²⁸ While some privatization proposals reject annuitization altogether,¹²⁹ others attempt to "shrink" the required level of annuities to provide enhanced opportunities for bequests.¹³⁰ One such proposal anticipates that the most "generous" option – allowing bequests equal to the remaining actuarial value of a participant's personal account – would reduce the overall level of annuities by approximately twenty-nine percent.¹³¹ Encouraging a higher level of bequests would seem sensible as a policy matter only if personal accounts are viewed essentially as simply another form of tax-favored savings.¹³²

125. See BOSWORTH & BURTLESS, *supra* note 11, at 24-25.

126. See *id.* at 24 (noting that investment strategy of annuity provider implies that annuitants must accept "the riskless real rate of return" on their annuities).

127. See CONG. BUDGET OFFICE, SOCIAL SECURITY PRIVATIZATION AND THE ANNUITIES MARKET 25 (1998).

128. According to this view, mandatory annuitization would encourage unduly high levels of consumption and penalize "thrifty" retirees who wish to preserve some portion of their account balances to pass on to their heirs. See ADVISORY COUNCIL REPORT, *supra* note 3, at 117 (statement of Joan T. Bok et al.); Diamond, *supra* note 69, at 45 (noting political issues raised by contrasting views of "wealth entitlement" and "retirement income entitlement"); Kent A. Smetters, *Thinking About Social Security's Trust Fund*, in PROSPECTS FOR SOCIAL SECURITY REFORM, *supra* note 9, at 214 (noting that some individuals may wish to use their account balances to make gifts or bequests).

129. See ADVISORY COUNCIL REPORT, *supra* note 3, at 30 (discussing PSA plans).

130. See generally MARTIN FELDSTEIN & ELENA RANGUELOVA, THE ECONOMICS OF BEQUESTS IN PENSIONS AND SOCIAL SECURITY (Nat'l Bureau of Econ. Research, Working Paper No. 7065, 1999).

131. See *id.* at 31.

132. Cf. *id.* at 3 ("[The] same inability to do long-term saving can also justify helping individuals to make the bequests that they would like to make but lack the ability to achieve.").

III. Conclusion

Although any proposal to privatize all or part of the Social Security system raises significant administrative issues, the implementation of personal accounts does not appear to present insurmountable practical obstacles. It is important, however, to understand that the federal government would undoubtedly play a substantial and continuing role, even in a privatized system. Some functions, such as collecting contributions and transmitting them to personal accounts, might readily be ceded to the government in the absence of competition from the private sector. Other functions, however, such as defining investment and withdrawal options and monitoring financial service providers, are likely to prove more controversial. A move in the direction of a privatized system would inevitably require a tradeoff between competing goals. On the one hand, the principal rationale for personal accounts is to give individual participants more control over their own funds and, as a corollary, to remove those funds from the reach of the government. On the other hand, any viable system of mandatory retirement saving must equip individual participants to make responsible and informed investment decisions and must also provide safeguards against fraud.

A centralized system modeled on the TSP could balance these goals by offering participants a relatively narrow range of investment and withdrawal options with correspondingly low administrative costs and limited risks. Alternatively, a decentralized system could offer a broader range of options coupled with higher costs and greater risks. Ultimately, the choice between these approaches reflects controversial judgments about values and politics, as does the broader debate over the direction of Social Security reform.¹³³ Some may perceive a centralized system as imposing unnecessary constraints on individual choice and unacceptable risks of government interference in private markets. Even proponents of a decentralized system with enhanced individual choice, however, may find a basic low-cost plan desirable as a default option. A two-tier system, combining a basic low-cost plan with more flexible supplemental options, might balance competing goals while mitigating the need for intrusive government regulation. Even in a two-tier system, however, it may be necessary to limit available options in order to protect individual participants and to preserve the integrity of the system.

A system of personal accounts is often viewed as providing benefits not available under the existing Social Security system. These benefits include potentially higher returns, expanded investment choices, greater individual equity, and long-run increases in national savings and productivity as a result of switching from a pay-as-you-go system to an advance-funded system.

133. See Burke & McCouch, *supra* note 11, at 426.

Whether these benefits can actually be achieved is likely to depend crucially on details of structure and implementation. In designing a system of personal accounts, it is imperative that the inevitable tradeoffs be carefully considered at the outset and not left to be resolved at some indefinite future time. Only when administrative issues have been squarely confronted will it be possible to make a balanced assessment of the potential benefits relative to the risks and costs of personal accounts.